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The Conference Board

Economic and Business Environment Program

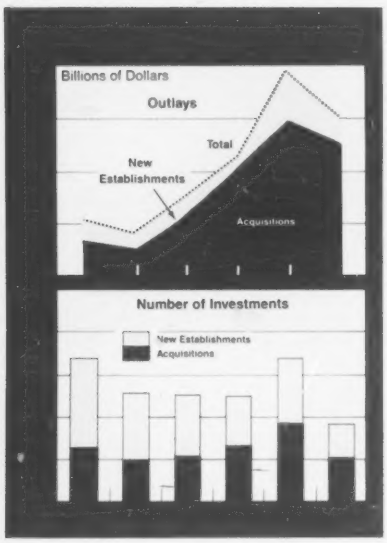
World Economic Monitor

Volume 3, Number 4 Fall 1988

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

Spending by foreigners to acquire or establish U.S. business enterprises fell noticeably last year, but remained substantially higher than at any time prior to 1986 (Chart 1). Last year's decline partly reflected changes in U.S. tax law under the 1986 Tax Reform Act that were less favorable to mergers and acquisitions and thus prompted a surge of foreign investments in the fourth quarter of the year. The *number* of new foreign investments has shrunk by about 50 percent since the early 1980s. This simply means that, just like in the domestic economy, individual deals have become very much larger.

Chart 1



Source: Department of Commerce

The biggest foreign acquisition in 1987 amounted to $7.6 billion. A $3.1-billion purchase took second place and the ten largest had a combined value of $22.9 billion. Only 60 percent of last year's transactions involved outlays of under $10 million, compared to over 80 percent in 1981 and 1982. Nevertheless, foreign acquisitions in 1987 continued to be dwarfed by mergers and acquisitions among U.S. firms, which were almost three times as large in value and ten times as many in number.

Several factors continued to render direct investment in the United States attractive to foreign firms:

*Last year's decline in the exchange value of the dollar not only lowered the cost of acquiring U.S. enterprises, but also induced foreign companies to shift more of their operations to the United States in order to maintain market shares.

*Corporate restructuring in the United States led many companies to shed units that were either unprofitable or unrelated to their major lines of business.

*Continued large trade surpluses in major foreign countries made funds available for investment abroad—and raised the spectre of increased protectionism in the United States.

*A number of large foreign multinationals were eager to expand and diversify beyond their own, much smaller home markets.

How Large A Presence?

In the heat of the debate over the "buying up" of the U.S. economy by foreign interests, it is often forgotten that foreign direct investment constitutes only a relatively small part of the continuing wave of incoming foreign capital. Thus, at the end of 1987, foreign direct investment accounted for only 21 percent of the nearly $1.3 trillion in privately owned foreign dollar assets. Correspondingly, last year only $10.5 billion was earned by foreigners from their direct investments in the United States, compared to $72.8 billion in earnings from financial assets.

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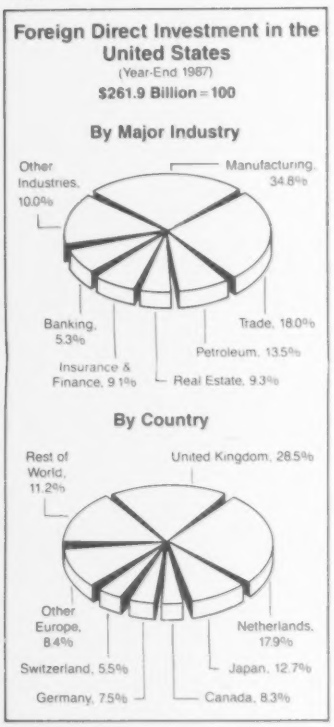
Chart 2



Source: Department of Commerce

Nevertheless, the question frequently is raised how prevalent the foreign presence in the United States has become. The most satisfactory measures available are 1) employment by foreign-owned U.S. affiliates relative to total employment, and 2) the share of foreign affiliates' assets and sales in major manufacturing sectors. (At the industry level, employment comparisons are not appropriate, since affiliate data by industry are gathered at the company level, while U.S. employment is classified by industry on an establishment basis).

In 1986 (latest year available), employment in foreign-owned affiliates accounted for 3.5 percent of total U.S. nonbank employment. For manufacturing alone—which accounted for over one third of foreign direct investment (Chart 2)—the affiliates' share of employment was 7.8 percent. These percentages look rather modest in light of the sharp rise in foreign direct investment in recent years. But they apply to a large base and there has been only limited investment by foreign interests in the service sector, which now accounts for about half of the U.S. economy. By individual state, there is only limited variation in the share of employment provided by foreign-owned firms (Table 1).

By assets and sales of major industry groupings, however, the foreign investment data are somewhat more revealing. They show, for instance, that direct investment is highly concentrated in certain industries, such as chemicals; stone, clay, and glass; and primary metals (Table 2). For manufacturing as a whole, the affiliates' share in total assets of all U.S. businesses was 12.1 percent in 1986—higher than their share of total U.S. employment (7.8 percent). This reflects the fact that foreign affiliates are most heavily represented in industries—such as chemicals and petroleum and coal products—that tend to be capital-intensive.

By a different measure, the U.S. affiliates of foreign companies also are fairly prominent on the U.S. economic scene—they are major exporters and importers. In 1986, affiliates provided 22.4 percent of total U.S. exports and took in 34.0 percent of all U.S. imports. The U.S. affiliates of Japanese parent companies, including the large trading houses, accounted for more U.S. trade than affiliates from any other country. In fact, the value of exports by U.S.-based Japanese-owned enterprises was equal to about 85 percent of total U.S. exports to Japan in 1986.

Foreign-owned affiliates in the United States have consistently shown a fairly large trade deficit and in 1986 contributed almost half of the overall U.S. deficit. This reflects the general trading pattern of foreign affiliates everywhere: They rely on their home countries, and particularly on their parent companies, for shipments of parts and components for further processing. By the same token, U.S. trade with the foreign affiliates of U.S. companies has consistently been in surplus. (What this implies for an accurate reading of the monthly trade figures is another story).

At best, any measure of the foreign presence in the U.S. economy is an approximation. For example, "foreign ownership" is defined as 10 percent or more of a firm's equity, but data on U.S. affiliate operations are not adjusted to reflect the various degrees of such ownership. Thus, in Delaware, "foreign" employers in 1986 provided work for as much as 11 percent of the state's labor force—simply because Delaware's single largest employer is 23 percent foreign-owned. Commerce Department estimates suggest that employment by foreign affiliates at industry level would be about 20 percent lower if it were adjusted for the actual percentage of foreign ownership.

Table 1
Share of Employment of Foreign-Owned Nonbank Affiliates, 1986
(By State)

State*	*Affiliate Employees* (thousands)	*Percent of State's Nonfarm Employment*
California	284.5	2.5
New York	284.5	3.5
Texas	211.3	3.2
New Jersey	161.7	4.6
Illinois	153.2	3.2
Pennsylvania	152.4	3.1
Ohio	127.1	2.8
North Carolina	119.2	4.3
Georgia	109.0	4.0
Florida	107.4	2.3

*Top ten states by number of foreign employment
Source: Department of Commerce

The U.S. Direct Investment Position

There has been much discussion lately of the United States as an international debtor—according to some versions, with a foreign debt larger than that of Brazil or Mexico. It would be more accurate to say that the U.S. international investment position has turned negative. Within this total picture, however, the U.S. position on direct investment has remained in the black (Chart 3) and may even be understated due to problems with the data.

For example, it is generally agreed that the book value of U.S. assets abroad, which is carried in the official statistics, is below actual market value. True, the book-value principle also applies to foreign direct investment in the United States, but in this case the degree of undervaluation is much smaller, simply because the investment is of much more recent origin. This undervaluation, plus other anomalies in the data, cast some doubt on the entire notion of the U.S. "debtor" position.

Foreign Direct Investment: Bane or Boon?

The rapid growth in the foreign presence in the United States in recent years is seen in many quarters as implying a loss of U.S. sovereignty and control over its own economy. Earlier this year, two prominent figures from the private sector voiced their concern over this "invasion." In January, Malcolm Forbes wrote in an editorial: "It's one thing for Japanese and Germans and others to buy U.S. Government bonds to finance our huge trade imbalances with them. But it's a whole and totally impermissible other thing for them to use their vast billions of dollars to buy great chunks of America's big businesses or take over the high-tech, medical or other strategic U.S. concerns." Forbes therefore proposed creation of a presidential commission to approve all foreign purchases of any significance, regardless of size.

Table 2
Foreign-Owned Affiliates' Shares in Assets and Sales of U.S. Manufacturing Industries, 1986

	Assets (%)	*Sales* (%)
Industries*		
Chemicals and allied products	32.5	29.5
Stone, clay, and glass products	22.8	20.2
Primary metal industries	20.5	19.0
Petroleum and coal products	14.9	13.7
Printing and publishing	11.8	8.0
Electric and electronic equip.	11.3	11.7
Food and related products	9.5	6.8
Paper and allied products	8.1	7.1
Fabricated metal products	7.6	6.3
Instruments and related products	6.4	5.7
All manufacturing	12.1	9.9

*Top ten industries by degree of foreign involvement
Source: Department of Commerce

Also, in January, in a speech to the Economic Club of Washington, Felix Rohatyn described himself as a recent convert to the idea of restricting foreign investment capital. He argued that recent stock market trends had created a dangerous vulnerability. Japan's Fuji Bank has a current market value, he noted, of $60 billion, or ten times that of Morgan Guaranty, while Toyota dwarfed Chrysler by $40 billion to $4 billion. Thus, he added, "it does not require a get leap of the imagination to see Japanese companies able to acquire controlling interests in major American companies at a relatively small cost to themselves...No major industrial power in the world, certainly not Japan, not even Great Britain, allows foreign control of major companies to be acquired without governmental approval." Rohatyn stressed that he was not proposing actual limits on foreign investment, but thought it logical to extend the review mechanism now in place for acquiring defense-related companies to "other sensitive areas."

These and related concerns found their way into a number of provisions in the trade bill debated by the U.S. Congress earlier this year. These provisions—which did not survive in the final version of the bill passed in July—would have reversed traditional U.S. policy by discriminating against foreign investors. Two particularly drastic provisions were included in the original House version of the bill:

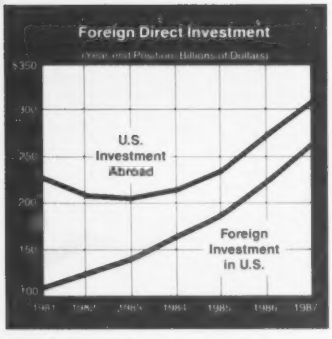
*A general registration requirement for foreign direct investors that would have forced them to disclose to the Department of Commerce financial and other corporate information not required of U.S. investors.

*General authority for the U.S. government to deny any investment or other transaction involving foreign firms thought to have adverse consequences for "national security and essential commerce."

Many observers, including public officials and major business executives, warned that any attacks on foreign direct investment in the United States would be tantamount to economic suicide. Former Federal Reserve Chairman Paul Volcker declared it not "in the best interests of he United States to discourage inflows of foreign capital," while the National Association of Manufacturers' President, Alexander Trowbridge, asked, "Why destroy our economy's greatest asset, a relatively free and open market?...We must look at these increasing inflows as part of a process of the competitive maturation of European- and Japanese-based international business enterprise." Similar feelings were expressed by senior executives of major U.S. corporations. They urged dropping the disclosure measure to avoid provoking retaliatory measures abroad.

One could add to these observations that changing the rules under which foreign direct investment enters the United States could easily discourage foreigners from holding any form of dollar assets, including U.S. Government securities—as well as drive up interest rates sharply. It is also possible to argue that for most of its history, the development of the U.S. economy was financed heavily by foreign investors, without giving them undue influence over the economy and U.S. economic policy.

Chart 3



Source: Department of Commerce

Certain protection procedures against foreign takeovers are already embodied in law and the Committee on Foreign Investment in the United States serves as a broader review mechanism. This group, made up of representatives of government agencies, was formed by executive order during the Ford Administration to ensure that OPEC funds (the so-called petrodollars) would not be used to buy up the U.S. oil industry. The committee can recommend against a foreign takeover or for altering the terms of a proposed takeover and actually has done do in a few cases. (Beyond these limited control mechanisms, one could conceive of a general overhaul of takeover legislation—but on a nondiscriminatory basis, applied to all investors, domestic as well as foreign).

Meanwhile, foreign direct investment will undoubtedly continue to come to these shores, even if at a somewhat slower pace than five to ten years ago. Given that the stock market valuation of all U.S. companies is on the order of $2 trillion ($2,216 billion at the end of 1987), it seems unlikely that direct investment will come to occupy an unduly large fraction of U.S. business as a whole. It is, nevertheless, quite possible that foreign investors will continue to concentrate in selected industries, thus stirring repercussions similar to those aroused by *le défi américain* of twenty years ago.

The Conference Board

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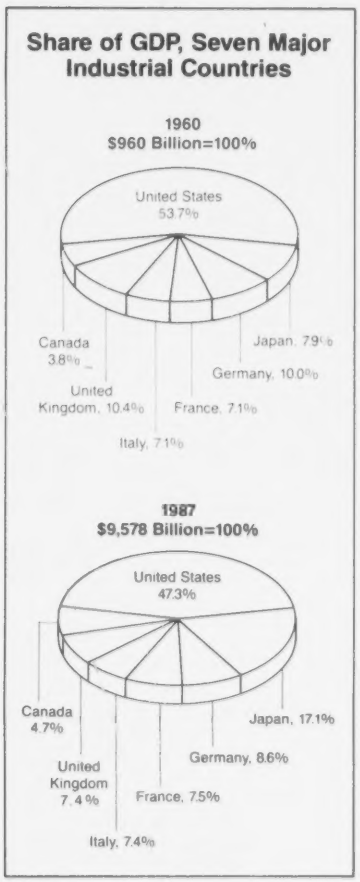
Volume 4, Number 1 Winter 1989

THE UNITED STATES IN THE WORLD ECONOMY

The internationalization of the American economy has outrun people's understanding of its implications. More than ever before, we cannot put our own house in order except by relating the American economy to the rest of the world.

William Diebold, Jr. in *Foreign Affairs,* Fall 1983.

Chart 1



Sources: Bureau of Labor Statistics; Brookings Institution; International Monetary Fund.

The economic relations of the United States with the rest of the world are vastly different today compared to 40 years ago, when this author began working in economic research. A seminal Commerce Department study of 1943, which was required reading in graduate school, viewed the international transactions of the United States basically in terms of "dollars made available to foreign countries. . .through purchases of goods, services, and investments abroad and the uses to which dollars are put by foreign countries in making similar purchases from the United States."

That fundamental equation still holds true, but the importance and weight of the participants, as well as the nature and volume of transactions in both directions, have changed considerably. As recently as 1960, official U.S. economic and military aid exceeded U.S. direct investment abroad, and until 1970 the United States enjoyed annual trade and current-account surpluses. By the late 1960s, however, import growth began to exceed export growth, and foreign direct investment in the United States started to rise more rapidly than U.S. direct investment abroad. By the late 1970s, the United States was attracting vast amounts of goods, services, and capital from abroad and was moving from a state of near self-sufficiency to one of international interdependence.

In the process, there have been major changes. Over the past 30 years:

- The share of the United States in the world economy has shrunk.
- The share of U.S. gross national product sold abroad has doubled, while the share of GNP spent on foreign goods and services has almost tripled.
- The dollar lost some of its preeminence, but remains the major international currency, for both official and private use.
- International capital flows have replaced trade in goods as the major type of international transaction.
- In this new environment, international economic policy cooperation is assuming an increasingly important role.

The U.S. and the World

The position of the United States in the world economy has shrunk over the last 20 to 30 years. The U.S. share of world gross domestic product fell from 27 percent in 1950 to 18 percent in the mid-1980s and its share of the output of the seven major industrial countries from 54 percent in 1960 to less than half in 1987 (Chart 1). This is generally ascribed to "catching up" by other major countries, especially Germany and Japan, and does not necessarily denote a worsening of long-term economic performance. The U.S. economy, Robert Lipsey and Irving Kravis note,

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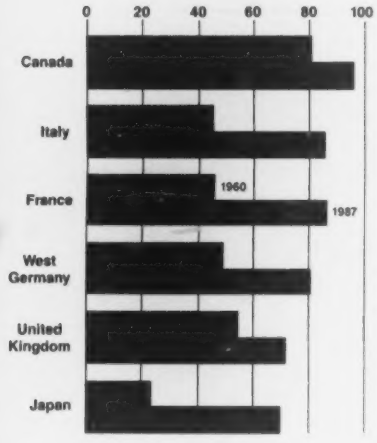
was "like a ship moving at its familiar moderate speed, while most of the other vessels that once lagged far behind, began to accelerate." What changed, in other words, was considerably more rapid economic growth in the rest of the world.

While the United States obviously loses some clout when other countries prosper, the well-being and living standards of its citizens are enhanced at the same time. A more interdependent world economy and economic growth abroad give the Untied States access to new and growing markets, allow it to benefit from other countries' technological innovations, and offer the U.S. consumer a greater variety of goods and services.

Chart 2

Relative Levels of GDP per Worker, Major Industrial Countries

(United States=100)



Sources: Bureau of Labor Statistics, Brookings Institution.

True, over the past 15 years U.S. productivity growth has slowed significantly and the real earnings of workers have stagnated. However, comparing the Untied States and other countries on that basis is a rather complex task. Judged solely by output per worker, the U.S. performance looks worst compared to other major industrial countries. The difference becomes more favorable, however, if productivity is measured by output per unit of labor input. By that measure, inexperienced workers represent less input than skilled ones. The difference is even less if one measures productivity by output per unit of labor and capital. The two oil shocks of the 1970s, for instance, affected the performance of the U.S. capital stock adversely, since it was older on average and hence less energy-efficient than that of most European countries and Japan.

By contrast, the difference in levels of output per worker, calculated on the basis of foreign currencies' actual purchasing power rather than market exchange rates, remains surprisingly large in America's favor. In 1987, for instance, the average French, German, and Japanese worker was still producing 14.7 percent, 18.9 percent, and 29.3 percent less than the average U.S. worker, according to this measure (Chart 2).

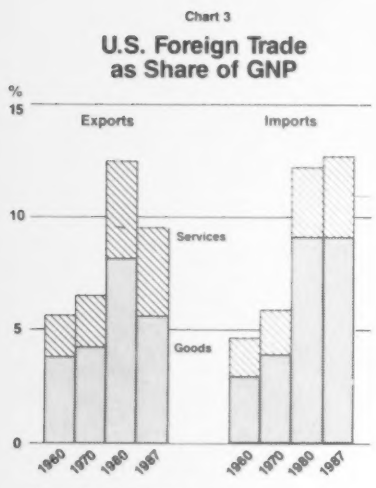
Comparisons based on actual purchasing power suggest therefore that U.S. living standards are still higher than those of other industrial countries. Such comparisons indicate that, while other countries may have done better than the U.S. in so-called tradable goods industries, they lag behind the U.S. in the distribution and service sectors. As Barry Bosworth and Robert Lawrenee of the Brookings Institution have observed, these countries' living standards would be considerably higher "if they could buy nontradable goods from the United States rather than at home. Because of the high cost of domestic nontradables, these nations...have much lower overall living standards than their efficiency in producing tradable goods would suggest."

The World and the U.S.

The increasing integration of the world economy has been reflected in more rapid growth of world trade than of world output since World War II. This phenomenon has been very pronounced in the case of the United States. Over the past 30 years, its growing involvement in the world economy has led to a doubling of the share of U.S.-produced goods and services going abroad and a near tripling of the share of U.S. gross national product being spent on goods and services purchased abroad (Chart 3).

Even at that rate, however, the United States remains one of the least "open" economies in the world, at least in terms of its merchandise trade. Other major industrial countries typically export between 20 and 30 percent of what they produce. Some smaller countries, such as Belgium and Ireland, export as much as half their GNP—for some, exports and imports combined equal or exceed GNP. As Governor Wallich of the Federal Reserve once remarked, with respect to its international transactions, the United States is like the ideal car—big on the inside, but small on the outside.

Chart 3



Source: Department of Commerce.

Increased involvement in the world economy has also incurred costs. With imports growing much more rapidly than exports and interest payments to foreigners now exceeding interest income on U.S. assets abroad, the U.S. external accounts have slid deeply into deficit. With foreign investments in the U.S. now exceeding U.S. investment abroad, the country has become, as the media like to put it, "an international debtor" (Chart 4).

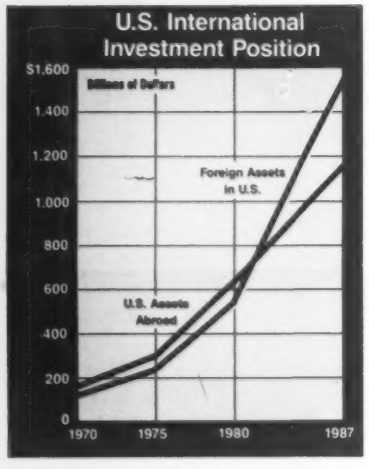
Theoretically, a current-account-deficit can always be financed. What matters is the mix of interest and exchange rates necessary to generate that financing. Because of the unique international role of the dollar, the United States has financing options not available to any other country—it pays for its external obligations in its own currency or what General de Gaulle once called an "exorbitant privilege." And while there is no specific point at which the deficit can no longer be financed, it is of course vulnerable to shifts in how foreign investors perceive trends in the U.S. inflation rate and in exchange rates.

Finally, there are those who view the external deficit of the U.S. as a sign of strength rather than of weakness. Thus, Milton Friedman wrote in *The Wall Street Journal* in December 1988, "The capital inflow that is the other side of the current-account deficit has enabled productive investment in the U.S. to be higher than the amount U.S. residents were willing to finance. It has thereby contributed to a higher national output and a more rapid rate of growth. That is precisely how the U.S. managed to grow so rapidly in the 19th century."

The Dollar's Changing Role

The shift in the international position of the United States has been closely associated with a corresponding change in the international role of the dollar. For a quarter century after the war, the stability of the U.S. currency was considered essential to world prosperity, and most countries regarded increases in their official dollar reserves as a sign of success in economic policy. In addition, the stability of the dollar in terms of gold was virtually unquestioned.

Chart 4



Source: Department of Commerce.

But when the perception of the United States as the center of the global economy began to fade, foreign countries began to reassess their attitudes toward the dollar. This reappraisal was stimulated, in part, by the U.S. authorities themselves: By the closing of the gold window in August 1971, the devaluations of the dollar late that year and in March 1973, and, perhaps more important, by the disinclination of successive Administrations to intervene to defend the value of the dollar in the exchange markets (or "benign neglect").

But the weakening of the role of the dollar can also be attributed to a growing disequilibrium between other countries' demand for the U.S. currency and the supply of that currency flowing into foreign markets. Especially in the 1970s, the total amount of dollars that foreigners desired, both to purchase goods and services from the United States and to add to official reserves, tended to fall well below U.S. financial outflows. The causes were numerous, including the inflationary financing of the Vietnam War. In a sense, this was ironic since the two world wars had helped to establish the dollar's preeminence and the international creditor position of the United States.

Yet even in the 1970s, reports of the dollar's imminent demise were exaggerated. They would be even more so now, when there is greater international economic cooperation. Although the dollar clearly has lost some of its lustre over the past thirty years, it has remained, virtually by default, the world's major currency. Its role as an international currency—both in the official and the private sphere—remains way out of proportion to the diminished role of the United States in the world economy. In 1987, the dollar still accounted for two-thirds of the world's official reserves (Table 1) and played an eminent role in international trade and investment (Table 2).

Surging Capital Flows

Table 1

Currency Composition of Official Foreign Exchange Reserves (In percent)

	1975	*1980*	*1987*
U.S. dollar	85.2%	68.6%	67.1%
Deutsche mark	6.6	14.9	14.7
Japanese yen	0.6	4.3	7.0
Pound sterling	4.1	2.9	2.6
Swiss franc	1.7	3.2	1.6
French franc)	1.7	1.2	
Netherlands guilder)	1.8	1.3	1.1
Unspecified currencies)		3.1	4.7
	100.0%	100.0%	100.0%

Source: International Monetary Fund.

The internationalization of the world economy has been accompanied—and at the same time hastened—by a sharp increase in the international mobility of financial capital. In contrast to the direct investment that characterized the period after World War II, these more recent capital flows generally do not involve direct control of business enterprises. The volume of such transactions has risen rapidly in recent years in relation to most other aggregates, such as output or trade. Between 1980 and 1986, for instance, world exports grew by 1 percent a year, while crossborder banking transactions grew by 15 percent annually.

Indeed, easily the biggest change in the world economy over the past 10 to 15 years is that flows of money have replaced trade in goods as the predominant type of international transaction—and hence as the prime force that drives exchange rates. Transfers of financial assets between countries now swamp the flow of revenues from trade in their effect on the demand for and supply of different currencies. Little is therefore to be gained by trying to divine the direction of the dollar from the monthly U.S. trade data as the media and the financial markets are wont to do!

A major implication of this phenomenon is the curtailment of the freedom a country's monetary authorities have to pursue their policies independently of developments and policies in other countries. In other words, without some sort of "coordination" of economic policies, exchange rates are likely to become still more volatile.

International Policy Cooperation

Table 2

The Dollar as an International Currency

Function	*Private Sector*	*Official Sector*
Unit of Account	Currency used in invoicing merchandise	Currency used in defining parities
Means of payment	Vehicle currency in foreign-exchange markets	Intervention currency in foreign-exchange markets
Store of Value	Currency in which deposits, loans, and bonds are dominated	Currency in which reserves are held

Source: Peter B. Kenen, *The Role of the Dollar as International Currency*, Group of Thirty, 1983.

A few years ago, Governor Wallich introduced a useful taxonomy of economic policy interaction among countries. To him, consultation/coordination/harmonization/cooperation were, in ascending order, "the terms by which nations recognize, sometimes reluctantly, that they are not alone in the world." Consultation includes not only the exchange of information, but also an explanation of current economic conditions and policies. Under cooperation, countries retain their national sovereignty, but allow the actions of other countries to influence their decisions. Harmonization is no more than a polite term, "indicating a somewhat greater reluctance to limit one's freedom of action." Ascending, finally, to coordination means relinquishing some or all decision-making powers to other countries or to international institutions. This, inevitably, involves some loss of national sovereignty.

Wallich concluded that growing world interdependence was not yet matched "by growing ability or willingness to cooperate in dealing with the results of interdependence." Probably, at the moment the best we can hope for is continued close and fruitful cooperation, such as is found in the G-5 deliberations, the annual economic summits, and the various other fora that deal with international economic and monetary affairs. In that respect, Governor Robert Heller of the Federal Reserve remarked last December, countries behave "like families that cooperate in certain neighborhood projects, such as snow removal, agreeing not to use noisy lawnmowers on Sundays, or keeping an eye on each other's houses to prevent burglaries."

Yet, even that process is still in its initial stages and, apart from occasional concerted intervention in the foreign exchange markets, little in the way of formally coordinated economic policy has emerged. Probably not enough is known about how the world economy hangs together to ensure that macroeconomic policy coordination would improve the outcome.

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Volume 4, Number 2 Spring 1989

THE CHANGING PATTERN OF WORLD TRADE

If we look at forecasts of the most dynamic world markets by the year 2000, we find medicine, health, leisure, information technology and optoelectronics singled out.

Corning Glass Works, *Annual Report*, 1988

Over the past few years, vigorous business activity in the major industrial and a number of developing countries has been accompanied by a surge in world trade. Both the dollar value and the volume of world exports reached record levels in 1987 and 1988. Additional, if somewhat more modest, gains are projected for this year.

At the same time, this upsurge contributed to—and perhaps even consolidated—major changes in world trading patterns under way for the past 10 to 15 years. Products traded reflect a general shift away from basic goods, such as iron, steel, and paper, to high-tech items, such as electronics and telecommunications equipment. And a number of Asian countries, especially the so-called newly industrializing countries (NICs), are now in the top ranks of world exporters.

These changes are likely to continue and even to intensify between now and the year 2000. They will coincide with further globalization of production and assembly facilities and significant shifts in population patterns—and hence in markets—between the industrial and the developing countries.

Total Trade Surges

Six consecutive years of growth have brought the volume of world trade to a record level, of close to one-third above the recession level of 1982. In 1987, the *value* of world merchandise exports rose by 18 percent, to a record $2.3 trillion, and by another estimated 12 percent, to $2.6 trillion last year (Chart 1). Or, in real terms, the *volume* of world trade expanded by 5 percent in 1987 and by another 7-8 percent in 1988. For 1989, the International Monetary Fund projects further growth of 5-6 percent.

As has been true after earlier business downturns, merchandise trade has recovered much more rapidly than world output. In each of the past three years, for instance, the growth in trade volume has considerably exceeded the more or less stable rate of 3.0-3.5 percent annual growth in world production (Chart 2). However, within this pattern there were important differences among major product groups:

- In 1987, manufactures resumed their traditional role as the most dynamic category of merchandise trade, after trailing minerals and fuels in 1986 (Chart 3).
- In volume terms, agricultural trade had its best year since 1981, increasing almost in line with the expansion of total trade.
- In contrast, trade in mining products—60 percent of which consists of fuels—grew by only 1 percent in 1987, after having been the fastest growing category in 1986.

External Imbalances Narrow

In 1988, the United States contributed approximately one-third of the year's growth in world trade, with a rise in export volume of over 25 percent or almost twice that

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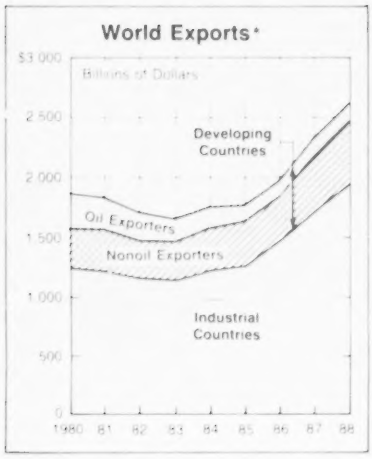
of 1987. The IMF estimates that by 1989 U.S. exporters are likely to regain most of the loss in market shares attributable to the appreciation of the dollar in the early 1980s.

Chart 1



*Excluding centrally planned economies
Source: International Monetary Fund

On the import side, growth last year was especially buoyant in Japan, with an estimated rise of 15 percent in volume terms, compared with 9 percent in 1987. Germany's import volume likewise is estimated to have grown by more than 6 percent in 1988.

Table 1
Current-Account Balances
(as percent of GNP)

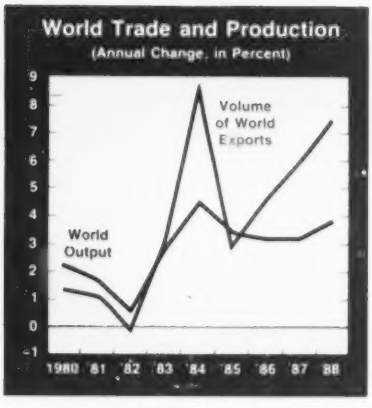
	1980	1986	1987	1988	1989 (est.)
U.S.	0.1	-3.3	-3.4	-2.6	-2.5
Japan	1.0	4.3	3.7	2.8	2.7
Germany	1.7	4.4	4.0	4.1	4.3
Four Asian NICs*	6.8	10.8	11.2	8-10	5.5-7.5

*Hong Kong, Korea, Singapore, and Taiwan
Sources: International Monetary Fund; Commission of the European Communities.

These shifts in export and import patterns are leading to a significant narrowing of trade imbalances, in volume terms. Progress is less evident when balances are expressed in dollar terms, because of fluctuations in exchange rates. Relative to gross national product, however, the imbalances in the current account of the United States and of Japan are projected to narrow by 1 percentage point between 1987 and 1989. The combined current-account surplus of the four Asian NICs is likewise projected to decline (Table 1).

The current surplus of Germany, on the other hand, is forecast to rise slightly relative to GNP. This reflects a number of factors, including brisk worldwide demand for the types of capital goods in which Germany specializes and weaker domestic demand growth vis-a-vis the country's trading partners.

Chart 2



Source: International Monetary Fund

Table 2
Top 15 Products in World Trade
(by value)

	Share in total trade 1986	Rank 1986	Rank 1983	Rank 1973
Passenger cars	5.3%	1	2	4
Crude petroleum	5.2	2	1	1
Office machines and data-processing equipment	3.3	3	6	20
Textile yarn and fabrics	3.1	4	4	3
Clothing	3.1	5	5	9
Iron and steel	3.0	6	3	2
Petroleum products	3.0	7	13	7
Motor vehicle parts and accessories	2.6	8	7	8
Plastic articles and materials	2.5	9	8	15
Wood products and paper	2.2	10	10	6
Organic chemicals	2.1	11	18	18
Fruits and vegetables	1.7	12	14	11
Telecommunications equipment and parts	1.5	13	17	17
Natural and manufactured gas	1.5	14	9	47
Transistors and valves	1.4	15	19	48

Source: GATT

Shifts in Major Product Groups

The commodity pattern of world trade has been changing markedly in the 1980s, even more so if compared to the early 1970s. A strong expansion in trade for a great variety of manufactured goods contrasts with stagnation or decline in trade in primary commodities and iron and steel (Table 2). Particularly strong trade showings were made by office machinery/data processing equipment (up by an average of 15 percent a year in the 1980s) and telecommunications equipment (10.5 percent). In fact, the first ten items in Table 2 accounted for one-third of world trade in 1986.

Shifts among Major Trading Countries

Highly aggregated data tend to conceal often large differences in the trade performance of individual countries. Thus, increases in 1987 export volume ranged between 20 and 32 percent for several Asian countries. Expanding export volumes also were registered by some of the major debtor countries, as well as by some industrial countries, including the United States (Table 3). By contrast, other debtor countries, as well as OPEC as a group, recorded substantial declines in their exports.

Table 3
Top 15 Gainers in 1987 Exports
(by volume)

Hong Kong	32.5%	Singapore	19.0%	Norway	13.5%
Colombia	26.5	Thailand	17.5	Portugal	11.0
Korea	24.0	Brazil	15.0	Mexico	11.0
Turkey	22.5	U.S.	15.0	Malaysia	8.5
Ireland	19.0	Taiwan	14.5	Spain	7.5

Source: GATT

As mentioned, manufactured goods proved to be the most dynamic sector in world trade in 1987—and much of that reflected the continuing inroads made by the Asian NICs into the manufactures trade of the industrial countries (Table 4).

Trade and the World Economy

The developments in world trade in recent years are generally encouraging. In both 1987 and 1988, the expansion of trade has been well above the average for the 1980s. However, this positive trend must be tempered by the persistence of third-world debt and the continuing large imbalances among the three leading trading nations. World economic activity—and hence world trade—will also continue to be affected by patterns of inflation and unemployment and, perhaps equally important, by individual countries' policy responses to those developments.

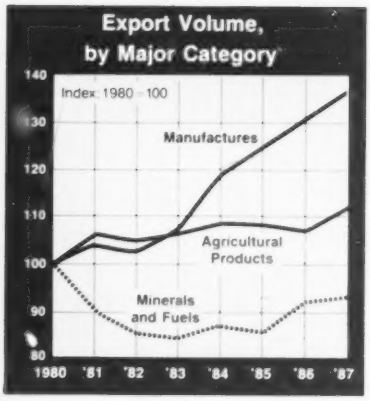
But there are also two longer term trends that will have an impact on how world trade develops and what patterns it will exhibit. The first is population. The latest UN projections indicate that the industrial countries are entering an era in which they can less and less afford the lower economic growth that results from delayed or bungled structural adjustments. The industrial countries will account for only 50 out of each 1,000 new people added to world population during 1990-2010. Thus, unless immigration policies are eased considerably, the industrial countries as a group are facing close to zero population growth, a gradually aging population, and a steady rise in the ratio of retired people to active workers. As a result, for many goods and services the greatest potential for market growth will have to lie in the developing countries.

The other trend concerns the impact of rapid technological progress. New and evolving technologies—including biotechnology, laser technology, optical fibers, and energy and space technology—are promoting product innovation and differentiation. They thereby broaden the scope of greater specialization and product diversification in international trade. These new opportunities are enhanced further by major advances in transportation which tend to reduce the cost of moving

goods internationally. At the same time, advances in telecommunications are stimulating the growth of trade in services and of global financial markets.

At the level of the individual company, all these changes have worked to internationalize production and distribution—to create the global factory—and have resulted in the growth of many small- and medium-sized firms whose economic health now depends on the availability of worldwide markets. This factor explains, in part, why trade has tended to increase more rapidly than world output.

Chart 3



Source: GATT

Table 4
World's 15 Leading Exporters of Manufactures
(share in value of world manufactures trade)

	1987	1980	1973
West Germany	15.2	14.8	17.0
Japan	13.0	11.2	10.0
U.S.	10.5	13.0	13.0
France	6.4	7.4	7.3
Italy	6.0	5.9	5.3
U.K.	5.7	7.5	7.0
Belgium-Luxembourg	3.6	4.1	4.9
Canada	3.3	2.8	3.5
Netherlands	3.3	3.4	3.9
Taiwan	2.8	1.6	1.1
Hong Kong	2.6	1.6	1.3
Korea	2.6	1.4	0.8
Switzerland	2.5	2.4	2.4
Sweden	2.2	2.2	2.6
USSR	1.8	1.8	2.2

Source: GATT

As the GATT reports in its 1987-88 review of world trade, the globalization of production and markets tends to increase the cost of non-tariff barriers to trade, even if the level of these barriers remains unchanged. As foreign goods become available in greater quantity and at lower cost, quantitative restrictions and other non-tariff measures limit consumer access to these opportunities. Such measures not only raise the prices of foreign goods (as was shown by the higher cost of Japanese car imports under the U.S. voluntary restraint agreement), but also ensure that price differentials continue to rise as foreign products become cheaper. As the GATT notes, "the resulting loss of economic efficiency is particularly damaging at a time when the challenges posed by worldwide population trends make higher rates of economic growth...more important than ever."

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THE DOLLAR AND U.S. TRADE

Only one thing is more impressive than the dollar's current strength: the ingenuity of economists in explaining its every move, always after the event, of course.

The Economist, May 20, 1989

The U.S. trade account's relatively good showing in March and April—with deficits of $9.5 billion and $8.3 billion, respectively—leads many observers to claim that the trade deficit's downward adjustment is continuing. Moreover, March's sharp 18 percent rise in merchandise exports (5.8 percent, seasonally adjusted) is cited as evidence that the U.S. economy is shifting its focus to external demand, just when domestic demand may be slowing.

Despite these promising signs, however, the bottom line is that little or no further improvement in the trade deficit will be seen this year, largely due to continuing substantial deficits in several key categories and the recent strength of the dollar.

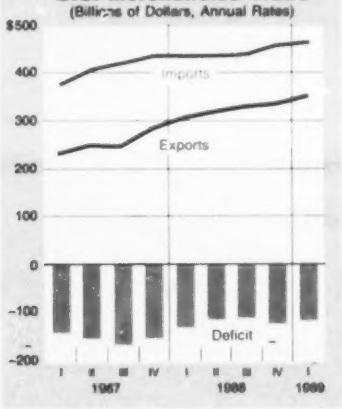
Trade Improvement Deceptive

Conclusions derived from monthly trade data have always rested on somewhat shaky ground. First, while the recent data look good, the first-quarter performance merely returns the trade deficit to levels reached in the second and third quarters of 1988 (Chart 1). Second, and perhaps more important, U.S. trade flows by sector show virtually no improvement in three key categories—automotive, consumer goods, and industrial supplies (including petroleum and petroleum products).

Chart 1

U.S. Merchandise Trade

(Billions of Dollars, Annual Rates)



Source: Department of Commerce

In the first four months of 1989, these three categories produced a deficit almost two-thirds larger than the overall trade deficit (Table 1). This contrasts unfavorably with the first four months of 1988, when the combined deficit of the same three categories was only one-third larger than the total deficit. In other words, when comparing these two periods, the bulk of the reduction in the trade deficit reflects improved trade in agricultural products and in the "other goods" category, which includes military equipment, low-valued shipments, and undocumented exports to Canada. The latter two figure among the top ten U.S. exports (Table 2).

Table 1

U.S. Trade Balance by Major Sectors ($ billion)

	Jan.-Apr. 1988	*Jan.-Apr. 1989*
Consumer goods	-22.0	-19.9
Automobiles	-18.9	-19.6
Industrial supplies	-10.5	-12.8
Other goods*	8.4	13.1
Capital goods	3.3	3.4
Food, feed, and beverages	1.6	4.0
Total	-38.1	-31.8

* Includes military equipment, shipments valued at $10,000 or under, undocumented exports to Canada, and U.S. goods returned.

Source: Department of Commerce

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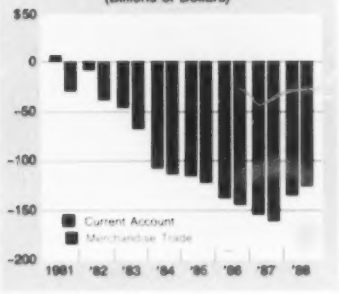
Table 2
Top Ten U.S. Exports and Imports, 1988

Exports	*Value ($ billion)*	*Imports*	*Value ($ billion)*
Aircraft	20.3	Motor vehicles	47.5
Vehicle and tractor parts	13.2	Crude petroleum	25.8
Office machine parts	12.6	Motor vehicle parts	14.7
ADP machines and equipment	11.6	Petroleum products	12.0
Shipments valued at $10,000 or under*	10.4	Office machine parts	11.5
Electronic components	10.4	Electronic components	11.5
Motor vehicles	9.1	Telecommunications equipment	9.7
Undocumented exports to Canada	8.3	Special transactions +	8.4
Organic chemicals	7.8	ADP machinery	8.3
Measuring and checking instruments	7.4	Footwear	8.0

* Over half of which to Canada
+ Mainly U.S. goods returned or reimported
Source: Department of Commerce

Chart 2
U.S. Balance of Payments
(Billions of Dollars)



Source: Department of Commerce

Even if the first four months' pace held for the remainder of the year, the deficit would only decline to around $110 billion from $120 billion last year. But even such modest improvement is unlikely to be achieved: Oil imports are set to rise over 1988 so that, even with prices unchanged, the oil import bill will increase. But even more important is the dollar's strength since early this year, which could result in a replay of the first half of the 1980s, leading to higher monthly deficits.

A stronger dollar would also perpetuate the decline in the value of U.S. corporations' repatriated earnings, thus worsening the already weak position of the services account. Although largely unnoticed, last year, for the first time, the deterioration in services resulted in an overall balance-of-payments deficit in excess of the deficit on merchandise trade (Chart 2). As recently as 1987, receipts of income on U.S. foreign assets (both direct and portfolio investment) had comfortably exceeded payments on foreign-owned dollar assets by over $20 billion. In 1988, that margin shrank to $2.2 billion, and in two of four quarters was actually negative. Preliminary data for the first three months of 1989 show payments to foreigners exceeding receipts by $3.5 billion. Even if the U.S. payments deficit remains at its current level, payments to foreigners on their dollar investments will continue to rise and thus offset whatever gains the trade account may register.

Sharing the Adjustment Burden?

While the three largest external imbalances—of the United States, Germany, and Japan—appear to be stabilizing or even declining slightly relative to GNP, in nominal terms these imbalances are projected to widen in 1989-90. Moreover, recent research by William Cline of the Institute for International Economics indicates that a reduction in the U.S. current account deficit may have unfavorable implications for its major trading partners. Cline finds that the cost of reducing the U.S. external deficit could easily be bigger external imbalances elsewhere. His model suggests that even if the dollar were to depreciate by another 10 percent against most currencies, countries that already have trade deficits would bear a disproportionately large share of adjustment, while the surpluses of Germany and Japan would remain virtually unchanged.

The reason is that both Germany and Japan have sizable trade surpluses with industrial countries apart from the United States. Since global payments and imbalances are recorded in dollars, a depreciating dollar will automatically boost the dollar price of German and Japanese exports and hence raise the value of their trade surpluses with those other countries. For deficit countries, such as France

and Italy, on the other hand, declining surpluses with the United States might be offset (or even more than offset) by bigger deficits with Germany and Japan.

Explaining the Dollar

Puzzlement surrounded the strength of the dollar earlier this year. At first, political uncertainty in both Germany and Japan were seen as contributing heavily to the dollar's rise. But this factor was quickly eliminated. Japan's new prime minister is untainted by the Recruit scandal. In West Germany, the popularity of the ruling conservative coalition received a boost from a cabinet shuffle, the abolition of the withholding tax on interest payments, and the Chancellor's strong stance in favor of negotiations on short-range nuclear weapons. While the events in China undoubtedly provided some "safe haven" support for the dollar in June, especially against the yen, this issue is receding as a market factor and will continue to abate unless the situation flares up again.

Once these considerations are discounted, there remains the argument that there now is a somewhat higher basic transactions demand for the dollar. But this explanation does not seem to square with the facts. Using the demand for international bank credit as a proxy for the worldwide demand for dollars, Deutsche Bank Capital Corporation notes that the share of international bank claims denominated in dollars fell from 76 percent at the end of 1983 to 58 percent at the end of 1988. Over the same period, the share of the yen rose from over 3 to almost 11 percent and that of the D-mark from 6.5 to 10 percent. (Even though half of these changes reflected exchange rate movements, the other half clearly was the result of increased volume.)

There is little validity to the further argument that foreign investors are currently "underinvested" in dollar assets and that the recent demand for dollars therefore represents an effort to "catch up." As counterpart to the deterioration in the net international investment position of the United States, foreign investors since 1982 have accumulated, on balance, nearly $700 billion of dollar assets, both direct and portfolio, giving them control, both directly and indirectly, of well over 10 percent of the U.S. capital stock and some 13 percent of the outstanding public debt.

An alternative explanation lies in the continued interplay or feedback between the U.S. balance of payments deficit and the inflow of foreign capital. Technically speaking, there is no apparent reason why the United States (or any other country) cannot run a current-account deficit indefinitely. Foreigners will not "run out of funds": The world economy is growing and, consequently, the resources available for lending are increasing continuously.

In fact, as Paul Krugman of MIT pointed out recently, the real world decisions that determine the current account do not change quickly. "For the most part," he notes, "the decisions that will determine the U.S. current account over the next two years have already been made." Even if the financial markets should become less bullish about the United States, they cannot do much to reduce the external deficit and hence the rate of capital inflow. Conversely, even if the United States becomes more attractive as a site for investment, capital inflows probably would not accelerate by much. If one subscribes to the notion that cause and effect run the other way, then continued strong demand for dollars and dollar assets would ensure continuation and even deterioration of the external deficit.

A Difficult Adjustment

The magnitude of the adjustment in the U.S. external accounts ultimately depends on two factors that, on the basis of recent experience, do not appear too promising—the responsiveness of the trade balance to changes in the dollar and the strength of economic growth abroad. Whether and by how much trade reacts to changes in the dollar depends on how the demand for U.S. goods responds to changes in their price relative to those of competing foreign goods, and also on whether and to what extent changes in import prices are actually transmitted (or

"passed through") by the foreign supplier. The weaker these responses are, the greater the decline in the dollar needed to achieve a given improvement.

Chart 3
U.S. Export and Import Prices

Sources: Bureau of Labor Statistics, Morgan Guaranty

Over the past few years, the responsiveness of U.S. exports and imports to changes in the dollar and in relative prices appears to have been significantly smaller than in earlier periods. This lower overall response may indicate that the U.S. consumer has become somewhat inured to the price changes of foreign-made goods. It certainly means that foreign producers have refused to fully "pass through" the effects of a weaker dollar to the prices charged to U.S. buyers (Chart 3). Thus, the Bureau of Labor Statistics estimates that between March 1985 and December 1986 foreign manufacturers of machinery and transport equipment—which is heavily influenced by exchange-rate fluctuations—passed through only 48 percent of price increases related to the decline of the dollar. In the most recent period—1986 to 1988—only 62 percent of such increases were passed through.

The strength of real growth in the U.S.'s major trading partners also has connotations for the U.S. trade balance. Reducing that imbalance requires some combination of slower domestic growth in the U.S. and dollar depreciation, both of which will have to be more pronounced the slower real growth abroad. Without adequate and sustained growth abroad, so the reasoning goes, it may well be impossible to achieve substantial further improvement in the U.S. trade deficit over the next few years. One obvious obstacle is that over one-third of the U.S.'s total trade in both directions is with but two countries, Canada and Japan (Table 3).

Table 3
Top Ten U.S. Markets and Suppliers, 1988

Market	*Percent of exports*	*Supplier*	*Percent of imports*
Canada	22.0	Japan	20.3
Japan	11.7	Canada	18.5
Mexico	6.4	Germany	6.0
United Kingdom	5.7	Taiwan	5.6
Germany	4.4	Mexico	5.2
Taiwan	3.8	Korea	4.6
Korea	3.5	United Kingdom	4.1
Netherlands	3.1	France	2.8
France	3.1	Italy	2.6
Belgium	2.3	Hong Kong	2.3
	66.0		72.0

Source: Department of Commerce

In the case of Canada, as much as one-third of trade is between U.S. companies and their Canadian affiliates, so that faster Canadian growth relative to the United States may not be very meaningful. In the case of Japan, sturdier domestic growth may very well translate into increased purchases of U.S. goods made in Japan, rather than into significantly higher U.S. exports, given Japan's still formidable structural and administrative barriers to such exports. As has been remarked repeatedly, even if all the barriers to trade were swept away, the U.S. would still record a bilateral trade deficit (albeit a somewhat smaller one) with Japan, just as it has since 1965.

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